No. 16025

United States
COURT OF APPEALS
for the Ninth Circuit

KLAMATH MEDICAL SERVICE BUREAU,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S BRIEF

Appeal from the Tax Court of the United States

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STATEMENT OF PLEADINGS AND BASIS FOR JURISDICTION

This is an appeal from a decision of the Tax Court of the United States which affirmed in part the determination of the Commissioner of Internal Revenue that

corporation income tax deficiencies exist as to the petitioner for the fiscal years ending June 30, 1951, 1952 and 1953. Appellate jurisdiction and venue are granted this Court by 26 USCA, Sections 7482(a) and 7482(b)(1). The Tax Court had jurisdiction by virtue of 26 USCA, Section 7442.

STATEMENT OF THE CASE

The petitioner is an Oregon corporation, organized in 1939, primarily engaged in the business of selling prepaid medical, surgical and hospital plans or contracts in Klamath County, Oregon, and providing the medical and surgical services and the hospitalization required under such plans or contracts (Tr. 50 to 53). A primary source of petitioner's income is the premiums paid upon the prepaid medical, surgical and hospital contracts or plans. Petitioner also derives income from non-contract patients for use of petitioner's hospital facilities (Ex. G, Tr. 151 to 155).

To meet its obligations for supplying medical, surgical and hospital services to those paying premiums under the contracts or plans, the petitioner entered into employment contracts with all of the physicians and surgeons of the Klamath County Medical Society. The employment contract with each physician and surgeon was the same, and the employment contracts (Ex. 23, Tr. 105) between the petitioner and the physicians and surgeons reads in part:

> "(1) In consideration of the benefits accruing to him, the Physician agrees to furnish professional services to the Bureau subscribers. * * *

"(3) The charges made by each Physician for services to members shall be initially based on the amounts provided by the Bureau fee schedule as now filed, but said schedule of fees is subject to change by the board of directors provided that notice of change is given in writing within three days to each Physician and that minimum fees not be reduced without prior notice. As full compensation for services rendered by Physicians hereunder, the Bureau agrees to pay and the Physician agrees to accept such percentage of each Physician's base fees charged and approved during each six month period prior to June 30 and December 31 of each year as the total net income of the Bureau for such period, less such amount as the board of directors determined should be retained for corporate purposes, bears to the total fees of all the Physicians during said period. Payment of 50% of the base fee shall be made within thirty days after billing and the balance at the end of each six month period."

The fee schedule in use in the years in question and referred to in paragraph 3 of the employment contracts is set forth in Ex. 12, Tr. 77. Such fee schedule specifies a flat amount for various types of medical services. The amounts set forth in the fee schedules are the "base fees" referred to in the employment contract. For example, a chronic appendectomy is $100.00, a tonsilectomy and adanoidectomy is $45.00 and a gastrotomy $175.00 (see Ex. 12). After performing medical or surgical services under his employment contract, a doctor submits a bill to the petitioner for the base fee specified in the fee schedule for the particular service rendered. The bill is submitted by the doctor to petitioner, and not to the patient receiving the services (Tr. 168). Within 30 days after receiving a bill from a doctor for

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REPLY BRIEF OF PETITIONER

Appeal from the Tax Court of the United States

ARGUMENT

a. Respondent ignores economic realities dictating the compensation arrangement.

Respondent's brief, like the Tax Court's opinion, chooses to ignore the economic realities which dictated the compensation arrangement between petitioner and the member physicians. The economic realities logically account for certain features erroneously referred to by the Tax Court and respondent as being indicative of profit distributions rather than payment of compensation for services rendered.

Petitioner was engaged primarily in the business of selling prepaid medical, surgical and hospital plans or contracts in Klamath County, Oregon, and providing the medical and surgical services and the hospitalization required under such plans or contracts. Petitioner is obligated under the plans to provide all the covered medical and surgical services required by the subscribers. The theory and purpose of prepaid medical, surgical and hospital plans is to provide for an undetermined quantity of medical services (depending upon the needs of the subscriber) for fixed periodic payments which can be budgeted by the subscribers. Consequently, the income of petitioner from the sale of the prepaid plans is fixed, while the amount of medical services to be performed pursuant to the plans is variable.

While the aggregate medical services required under prepaid plans may tend to average out over all the plans, the exact effect of such average cannot be relied upon, at least for a cross-section of subscribers as narrow as Klamath County.

It is elementary economics that costs cannot exceed income in any sound financial operation. Since petitioner's income was fixed, the only way in which petitioner could be sure that the costs did not exceed income was to make the costs dependent upon income. The costs of petitioner consisted primarily of compensation payable to physicians performing the medical services required under the prepaid plans.

Petitioners' obvious solution was to devise an arrangement under which the compensation to the physi-

cians could not exceed the income remaining after deducting sums retained for corporate purposes. This is exactly what Paragraph 3 of the employment contract accomplishes.

b. Respondent misconceives true import of petitioner's brief.

Not only does respondent fail to recognize the economic realities dictating the compensation arrangement attacked by him, but as indicated by the below quoted portion from his brief (Br. 13-14), respondent misconceives the true import of petitioner's brief:

> "If a distribution is not compensation, it quite obviously cannot under any circumstances be classified as "reasonable" compensation. Therefore, the pivotal question in this case is whether or not the excess payments were compensation for services or distributions of income. This issue has been largely ignored by the taxpayer on appeal, who has briefed extensively the question of whether or not compensation was reasonable or unreasonable."

Petitioner's brief is directed to a consideration of the specifications of error set forth therein. The first specification of error is the ultimate finding and conclusion of the Tax Court that the payments to doctors in excess of 100 per cent of the base fees specified in the fee schedule constituted distributions of profits rather than compensation. Respondent's statement of the pivotal issue is merely a rephrasing of petitioner's first specification of error. Petitioner's second, third and fourth specifications of error necessarily involved the same issue, such specifications being directed toward the subsidiary findings and conclusions upon which the Tax

Court bases the forementioned ultimate finding and conclusion.

Respondent is not justified in his accusation as to petitioner's briefing of the question of reasonableness, either in regard to the length or purpose of petitioner's consideration of this question. While reasonableness is a separate requirement for deductibility apart from the question of whether the payments are compensation, reasonableness is also an element often considered in determining whether payments constitute compensation or distribution of profits. The relationship between the amount of the payments purportedly made for services and the value of the services rendered obviously has a bearing upon whether the payments constitute compensation.[1]

c. Factors conclusively requiring compensation recognition.

Although a finding of reasonableness may be considered as evidence of the fact that the payments in question were compensation, such finding is not a prerequisite to substantiation of petitioner's contention that payments in excess of base fees were compensation. If respondent desires to exclude any consideration of reasonableness from the determination of whether the payments in excess of base fees constituted compensation or distribution of profits, petitioner is willing to adopt such

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[1] This is evident from a reading of Treasury Regulation Sec. 39.23 (a)-6 as well as the cases of *Doernbecher Mfg. Co. vs. Commissioner,* 95 F.2d 296; *Am-Plus Storage Battery Co. vs. Commissioner,* 35 F.2d 167; and *Marble & Shattuck Chair Co. vs. Commissioner,* 39 F.2d 393. These authorities are all cited in respondents's brief.

approach. Excluding reasonableness as an element to be considered, the following uncontroverted factors dictate the conclusion that the payments in excess of base fees were compensation rather than distributions of profits:

1. The payments were purportedly made as compensation.

2. The payments were made in direct proportion to the services actually rendered.

3. The payments were not in proportion to stock holdings of the recipients, but in fact were greatly disproportionate.

It is petitioner's pure and simple proposition that the combined existence of the foregoing uncontroverted factors necessitates the conclusion that the payments were compensation, and precludes any finding that the payments were distributions of profits. While every proposition may have exceptions in unusual circumstances, petitioner has been unable to find any case, and respondent has cited none, where the foregoing three factors have been present and the payments have been considered distributions of profit rather than compensation.[2] In fact, petitioner has been unable to

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[2] In the following cases cited by respondent, it was found both that the payments made were unreasonable in amount and were substantially in proportion to stock holdings: *Doernbecher Mfg. Co. vs. Commissioner,* 95 F.2d 296; *Am-Plus Storage Battery Co. vs. Commissioner,* 35 F.2d 167; *Marble & Shattuck Chair Co. vs. Commissioner,* 39 F.2d 393.

In the cases of *R. H. Oswald Co. vs. Commissioner,* 185 F.2d 6, certiorari denied, 340 U.S. 953; *E. Wagner & Son vs. Commissioner,* 93 F.2d 816; and *Becker Bros. vs. United States,* 7 F.2d 3, there was a finding that the payments made were unreasonably excessive. In *Heil Beauty Supplies vs. Commissioner,* 199 F.2d

find any reported case in which the Commissioner has previously contended that payments were distributions of profits rather than compensation where such three factors existed.

How can payments made in direct proportion to services actually rendered and disproportionate to stock holdings be seriously considered as anything other than compensation for services rendered? Do the laws of economics or human nature permit the serious imagination of any situation where a corporation would distribute earnings and profits as a dividend in direct proportion to services actually rendered and disproportionate to the stock ownership of the recipients?

d. Respondent practically ignores subsidiary findings and conclusions of Tax Court.

Since the Tax Court and respondent recognize the existence of the three factors set forth above, how do they purport to avoid the conclusion dictated by such three factors? The ultimate finding and conclusion of the Tax Court, that the payments in excess of base fees constituted a distribution of profits rather than compensation, is based on the following subsidiary findings and conclusions:

1. The contract between petitioner and the member physicians is ambiguous with respect to the compensation to be paid for services.

2. The following factors outside the employment contract resolve the ambiguity in the employ-

193, it was found that the payments bore no relationship to services rendered and that the services were of no economic value to the taxpayer corporation.

ment contract in favor of the interpretation that the doctors had obligated themselves under the contract to render services to petitioner for fees equal to those set forth in the base fee schedule and the contract does not require or specifically provide for payments of compensation to the doctors in excess of the base fees set forth in the fee schedule:

(a) Two of the contracts by which petitioner sells its services to subscribers provide that petitioner's member physicians accept petitioner's fees as payment in full for services to subscribers.

(b) In determining the book value of petitioner's stock for purposes of transferring shares thereof, only 100% of base fee billings are treated as Accounts Payable by petitioner.

3. Based on the testimony of the president of petitioner's Board of Directors, petitioner under the employment contract intended that all of its earnings in excess of amounts necessary for its operation, planned expansion and reserves, were to be distributed to its stockholder physicians, and, therefore, the employment contract provides not only a method of computation for services, but also a method for distribution of profits to stockholders.

How does respondent answer petitioner's contention that the subsidiary findings and conclusions of the Tax Court are erroneous and do not support its ultimate conclusion? Respondent practically ignored the subsidiary findings and conclusions of the Tax Court set forth above. Nowhere does respondent attempt to support the Tax Court's finding that the employment contract is

ambiguous. Neither does respondent expressly mention the Tax Court's holdings that under the employment contract the doctors had obligated themselves to render services to petitioner for fees equal to those set forth in the base fee schedule, or that the contract does not require or provide for payments of compensation to doctors in excess of the base fees set forth in the fee schedule. Perhaps respondent recognizes that whether the contract is ambiguous constitutes a question of law which this Court may determine as well as the Tax Court, or that respondent's stipulation as to the clear meaning of the contract (Tr. 59) conflicts with any finding of ambiguity.

No mention can be found in respondent's brief of the Tax Court's finding and conclusion set forth in Paragraph 3. above.

e. Independent arguments of respondent do not support ultimate finding and conclusion of Tax Court.

Rather than attempting to substantiate the subsidiary findings and conclusions actually made by the Tax Court, respondent attempts to support the ultimate finding and conclusion (that payments in excess of base fees were profit distributions rather than compensation) through independent argument hereinafter reviewed. The appropriateness of such arguments seems subject to question. The ultimate finding and conclusion of the Tax Court must stand or fall on the basis of the subsidiary findings and conclusions actually made by the Tax Court, not on respondent's version of what

the Tax Court should or could have specified as the basis for its ultimate finding and conclusion.

As before mentioned, the respondent makes no reference whatsoever to the Tax Court's holding that the employment contract is ambiguous. Neither does respondent support the interpretation of the employment contract made by the Tax Court. Rather, respondent points to several factors which he contends indicate that the fees set forth in the fee schedule were "* * * intended to compensate the member physicians for the services (Br. 16) * * * intended to be of a compensatory nature (Br. 16) * * * intended to be fully compensatory for the services rendered (Br. 18)." Even if the factors cited by respondent actually indicated that the fees set forth in the fee schedule were intended to be compensatory for the services rendered, respondent fails to explain exactly how this promotes the conclusion that the payments in excess of base fees were distributions of profits in view of the fact that the employment contract requires payments to physicians in accordance with the formula under the contract (undenied by respondent), which formula may generate full compensation in excess of the base fees as was the case in the subject years.

Two of the factors cited by respondent in support of the ultimate conclusion of the Tax Court are factors (a) and (b) set forth above under paragraph 2 of petitioner's outline of the Tax Court's subsidiary findings and conclusions. In regard to (a),—that the contracts by which petitioner sells its services to subscribers provide that member physicians accept K.M.S.B. fees as

payment in full for services to subscribers,—respondent makes the same unwarranted assumption as the Tax Court that the reference to "K.M.S.B. fees" means the fees set forth in the fee schedule rather than the full amount of compensation generated by the formula under paragraph 3 of the employment contract. Elsewhere in the contracts with subscribers where reference is definitely made to the fees specified in the fee schedule, the contracts use the term "fee schedule." An example of this is the provision in the contracts with subscribers for payments to non-member doctors for emergency care referred to by respondent at page 17 of his brief. Where the contract with subscribers provides for payment to non-member physicians, the reference is to the "fee schedule," while the before-mentioned reference to payments to member doctors is "K.M.S.B. fees." The difference in terminology would indicate a difference in meaning. Obviously, "K.M.S.B. fees" payable to member physicians means the full compensation payable pursuant to formula under paragraph 3 of the employment contract with each physician, while payments in accordance with the "fee schedule" to non-member doctors means the fixed fee specified in the fee schedule.

The foregoing furnishes the obvious answer to respondent's argument that because non-member doctors outside Klamath County receive payments from petitioner only to the extent of the fees set forth in the "fee schedule," the fee schedule was "intended to be fully compensatory for the services rendered" (Br. 17 and 18). This provision of the contracts with subscribers is a limitation upon the liability of petitioner to pay non-

member doctors who have no contracts with petitioner requiring them to accept the fees generated under the employment contract. There is no evidence that the non-member doctors accepted the fees set forth in the fee schdule as full compensation, or that petitioner intended the payments as such. The inference is quite to the contrary.

Respondent merely mentions as "noteworthy" (Br. 17) fact (b) mentioned above,—that in determining book value of petitioner's stock, 100 per cent of base fee billings were treated as Accounts Payable by petitioner. The treatment of base fees as accounts payable for the limited purpose of determining book value of petitioner's stock when such stock is transferred by the physicians, can in no way be interpreted as an indication that the physicians intended the fees specified in the base fee schedule to constitute full compensation. When a physician transfers stock of petitioner, he is terminating his relationships with the petitioner and what might be provided for purposes of determining the value of its stock upon such termination has no relationship to what the doctors agree to accept as full compensation for services rendered. Furthermore, this provision is perfectly logical when its function is explored.[3]

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[3] Accounts payable for services rendered will only exist when the book value of the stock is being determined during the six month intervals between computation and payment of the full compensation. The full compensation is not accruable under any sound accounting principles until determined at the six month intervals, and immediately upon determination that contract requires the payment of the amount so determined to the physicians. Therefore, no Accounts Payable exist for any appreciable time for the full compensation generated by the employment contract.

The other factors cited by respondent as purportedly indicating that the base fees were intended to be fully compensatory are not mentioned by the Tax Court as forming the basis for its findings and conclusions. Respondent refers to the requirement under the employment contract that the minimum fees may not be reduced without the prior notice. The proper inference to be drawn from this provision is quite the opposite of respondent's contention that the minimum fees or base fees are intended to be fully compensatory. Would it be logical for the doctors to permit the minimum fees to be reduced by merely giving prior notice if such minimum fees were intended as "compensation for services rendered"? The fact that the base fees may be reduced without the consent of the contracting doctors merely by giving prior notice is positive evidence that such base fees were not intended as full compensation but were merely the basis upon which full compensation is to be computed under the formula set forth in the employment contract.

Respondent contends (Br. 16) that evidence of the

However, during the six month intervals between determinations of the full compensation, there is a liability for the services rendered although the exact amount of such liability cannot be determined until the computation at the end of the six month period. How should such undetermined liability be set up on the books of petitioner for purposes of determining book value of the stock, or for any other purposes? The most logical answer is to set up Accounts Payable in the amount of the base fees specified in the fee schedule. This is the best that can be done under the circumstances where the actual amount of the compensation is unknown, and such furnishes no indication whatsoever that the doctors intended the fees in the fee schedule to constitute full compensation, or that the doctors agree to accept the fees in the fee schedule as full compensation.

intended compensatory nature of the base fees is afforded by the increase in the fees specified in the fee schedule effective during the years in question over the original fee schedule effective January 2, 1940. Any such interpretation is precluded by the fact that a uniform increase in the base fees has no effect upon the compensation generated by the formula in the employment contract. Petitioner again makes reference to the finding of the Tax Court that the fee schedule "was used for the purpose of differentiating between medical and surgical procedures and to insure member physicians would receive a like compensation for such services" (Tr. 28 and 29). The Tax Court attaches no such signifiicance as is advanced by respondent to the change in the fee schedule.

At pages 18 and 19 in his brief, respondent seems to attribute some adverse consequence to the fact that under the formula in the employment contract, the percentage of profits payable as full compensation is not determined until after the amount of the profits has been ascertained. Under the employment contract petitioner is obligated to pay to the doctors (in proportion to base fee billings) the net income of petitioner remaining after deducting such amounts as the Board of Directors determines should be retained for corporate purposes. The amount retained for corporate purposes, of course, affects the amount to be distributed as compensation, so the exact amount payable under the formula is not determined until after the profits have been ascertained. From this, respondent would infer that petitioner may use the formula under the employment contract as a

devious device for distributing all profits. Petitioner paid substantial income taxes during the years in question (Ex. G, Tr. 150). Under the employment contract petitioner is authorized to deduct such amounts as the Board of Directors determines should be retained for corporate purposes. There is no evidence whatsoever that the exercise of such authority by the Board of Directors was motivated by tax considerations. The possibility of tax abuse is all conjecture on the part of respondent. A discussion of this issue is contained in Mertens, Law of Federal Income Taxation (rev. ed., 1954) at Sec. 25.78 wherein the author cites the *Am-Plus Storage Battery Co.* case, *supra,* and other authorities and concludes "* * * The guiding principle in each case is whether the total compensation properly measures the value of the services of the recipient of the compensation as distinguished from the capital contribution which he makes as a stockholder." This test is conclusively answered in the instant case by the fact that the payments to the doctors were in direct proportion to services actually rendered and disproportionate to stockholdings.

Not only does respondent advance arguments in his brief not mentioned by the Tax Court as the basis of its findings and conclusions, but on pages 20 and 21 respondent asserts facts contrary to those found by the Tax Court. Respondent claims that some of petitioner's income derived from the operation of the hospital facilities was not due to the efforts of the doctors. As found by the Tax Court,

> "It is not true either that the doctors did not render services to the hospital. In a very real sense, but for the services they rendered to hospital patients, there would have been little, if any, hospital income." (Tr. 42).

In any event, there are many instances (which may be the rule rather than the exception) where the recipient of compensation based on profits cannot point to the fact that the income of the employer is derived exclusively from the direct result of his personal services.[4]

f. Restatement of petitioner's basic contention.

Respondent states (Br. 20) that a holding of compensation is not required by the fact the taxpayer and the physicians consistently referred to the payments in its corporate actions as compensation. Also, respondent claims that the lack of correlation between the payments and the stock holdings of the recipients is not determinative of the issue. Respondent misses the point of petitioner's basic argument. Petitioner has never contended that any one factor in and of itself is determinative of the issue. Rather, petitioner's contention is based upon the combination of all three factors set forth above. It is the impact of the three factors in combination which petitioner claims is determinative of the

[4] In the case of an executive officer of a manufacturing corporation, there are numerous elements other than the personal services of the executive which account for the income of the employer upon which the percentage compensation arrangement of the executive may be based. In the instant case, there is a much greater correlation between the payments to the physicians and the income of petitioner than usually exists in the ordinary situation of compensation based on profits.

issue. Where payments purportedly made as compensation, are in direct proportion to services actually rendered, and are not in proportion (but are disproportionate) to stock holdings, then the payments constitute compensation for the services rendered rather than profit distributions upon stock. Neither the Tax Court, nor respondent in his brief, recognizes the combined impact of these three factors. Although the Tax Court's findings of fact acknowledge the existence of the three factors, the opinion of the Court does not mention the possibility that the combined existence of such three factors may have a bearing upon the issue.

Instead of phrasing petitioner's basic proposition in terms of positive factors, the existence of which dictates the conclusion that the subject payments are compensation rather than profit distributions, petitioner's proposition may be expressed in terms of negative elements which must exist singly or in combination to warrant consideration of payments as profit distributions rather than compensation. No case discovered by petitioner, and none cited by respondent, substantiates the Commissioner's disallowance of compensation on the grounds that the disallowed portion constituted nondeductible profit distributions, unless one or more of the following factors were present:

(1) The parties called the payments profit distributions, or at least did not expressly refer to the payments as compensation.

(2) The payments in question were not made in direct proportion to services actually rendered.

(3) The payments were in proportion to the stock holdings of the recipients.

(4) The payments were unreasonable in relation to the actual value of the services rendered.

It is petitioner's understanding of the applicable cases that at least one of the above mentioned factors must be present before payments claimed as compensation deductions can be disallowed as profit distributions. In the instant case, none of the above adverse factors is present to support the Tax Court's ultimate finding and conclusion that the payments in excess of base fees were profit distributions rather than compensation. No other factors have, or logically can, support the ultimate finding of the Tax Court and thus such finding must fall.

g. Compliance with independent requirement of reasonableness.

The Tax Court was required to pass upon the reasonableness of the payments to the physicians because of respondent's contention that even a portion of the payments equal to base fees were unreasonable. Since the reasonableness of the payments in excess of base fees was immaterial in view of the Tax Court's conclusion that such payments were profit distributions rather than compensation, the extent of the finding as to reasonableness might have been limited to the base fees if evidence restricted to payments equal to base fees had been available and if the Tax Court had chosen to rely on such evidence.

Regardless of how the Tax Court *might* have passed

upon the reasonableness of the base fees, it *actually* grounded its finding upon the testimony of the physicians concerning which the Tax Court unequivocally states (Tr. 43): "* * * This testimony remains uncontradicted upon the record and we see no reason to give it less than its full weight." Such uncontradicted testimony accorded full weight was directed to the total amounts paid under the employment contracts, not just the amounts equal to base fees. In fact, such testimony expressly refuted the assertion that anything less than the full amount paid under the employment contract was reasonable. When full weight is given to uncontradicted testimony, the facts established thereby include the fact to which the testimony is directed, not merely some lesser facts encompassed therein even though such lesser facts may be the only ones pertinent to the issue then being decided. No logical basis exists for giving effect to the testimony of the physicians up to 100% of base fees and then disregarding same for the payments in excess of base fees. Consequently, the before-mentioned finding of the Tax Court constituted a finding of reasonableness for the full amounts paid under the employment contracts, or at least such a finding is mandatory under the circumstances.

Furthermore, where there are sound enocomic reasons for a compensation arrangement based on profits, the amount of compensation generated the reunder is deductible even though such amount may prove to be greater than what might otherwise be paid. This is the clear import of Paragraphs (2) and (3) of the regulation quoted on pages 4 and 5 of respondent's brief. The only

limitations contained in this regulation dealing with contingent compensation is that "* * * the compensation paid may not exceed what is reasonable under all the circumstances." The circumstances to be considered include the fact that the formula under the employment contract could generate compensation less than base fees, as well as compensation in excess of base fees, and that such compensation arrangement was the only feasible method by which petitioner could met the economic necessities of the situation.

Respectfully submitted,

MAUTZ, SOUTHER, SPAULDING,
DENECKE & KINSEY,

by.....